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TAGS: [ECON](#) [EFIN](#) [EINV](#) [HK](#) [CH](#)
SUBJECT: CHANGING VIEWS OF CHINA'S ECONOMY HIGHLIGHTED BY
HONG KONG SHARE RALLY

Classified By: EP Section Chief Simon Schuchat; Reasons: 1.4 (b/d)

SUMMARY AND COMMENT

1. (C) SUMMARY: Prices of mainland corporate shares (H-shares) in Hong Kong, arguably a barometer of market views on prospects for mainland growth and currency appreciation, have increased dramatically in recent months, rising 26 percent so far this year. Financial strategists tell us that the rally signifies three things: greater investor confidence in balanced economic growth in the PRC; expectations of renminbi appreciation; and belief in the ability of higher-quality Chinese companies to manage economic shocks. Also fueling the rally has been a decision to include mainland corporate shares in Hong Kong's benchmark stock index later this year. COMMENT: Placing H-shares in the Hang Seng Index will not only symbolize Hong Kong's ongoing economic integration with the mainland, but will also be yet another concrete step in the ongoing transformation of Hong Kong's exchange from a local market geared towards bank and property concerns to a global market with an emphasis on China plays. END SUMMARY AND COMMENT

UP, UP, AND AWAY

2. (U) H-shares are the primary vehicle through which China's state-owned enterprises use stock issuances to sell pieces of themselves to foreign investors. The 120 H-share companies that are listed in Hong Kong represent entities incorporated on the mainland, most of them state-affiliated. China Construction Bank, the world's largest initial public offering last year (USD 9 billion), is an example of an H-share. Such issuances are the primary source of new business for Hong Kong's exchange and already account for 16 percent of market capitalization. If other categories of mainland-affiliated firms are added in, then the market capitalization proportion rises to 39 percent.

3. (U) The principal index for tracking H-shares (the Hang Seng Mainland Composite Index or HSMCI) has risen 26 percent this year, a significant rally by comparison with 6 percent rise for the benchmark Hang Seng (HSI), the index of 33 stocks generally tracked by financial news services when reporting on Hong Kong; this index does not include H-shares.

FACTORING IN RENMINBI APPRECIATION...

14. (SBU) JP Morgan Managing Director Grace Ng said that H-share investors increasingly anticipate significant appreciation this year of the Chinese renminbi (RMB); Ng herself predicts a 12 percent upward RMB movement against the USD. H-share values are rising accordingly, since their fundamentals are to a great degree valued in RMB. Ng noted a significant trade-weighted rise in the RMB last year (without providing a calculation, although another contact has concluded that there was an 8 percent trade-weighted appreciation). China will be in a better position to let the RMB appreciate against the USD in 2006 because the USD is unlikely to continue its rise against the Euro and Yen. In other words, Ng is suggesting that RMB-USD appreciation is easier for mainland policy makers to swallow now because it is unlikely to exacerbate an ongoing trade-weighted rise against other global currencies.

... WHICH IS A VALUABLE POLICY TOOL

15. (C) Further, according to Ng, investors may appreciate that RMB-USD appreciation is suddenly a valuable policy tool for officials in Beijing for three reasons. First, the National People's Congress will be held in early March and will formally approve the Eleventh Five-Year Plan. This offers a roadmap towards domestic-focused growth and a more balanced economy less dependent on exports and investment. Currency appreciation coupled with maintaining low domestic interest rates fits in with promoting this scenario. Second, Congressional pressure from the U.S. and the prospect of being named a "manipulator" in Treasury's currency report matters to the Chinese, who do not want the door opened to unilateral trade sanctions that could harm their economy and financial markets. (Note: Ng stands out relative to other

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contacts here, who believe U.S. pressure could backfire because the mainland would not want to be seen as bowing to American demands just as President Hu Jintao is about to visit the U.S. End Note.) Finally, recent positive growth figures (e.g., January's surprisingly strong export data) suggest that China has room to absorb the retarding effects of appreciation. Confidence in prospects for appreciation has been only bolstered by faster upward movement of the RMB seen this month, since the end of the Chinese New Year, according to Ng.

ECONOMIC CENSUS ALSO HELPS H-SHARES...

16. (C) Ng referred to China's recent economic census that led to a 17 percent upward revision of the size of its economy. The change was primarily a result of recognizing the larger role played by services than previously thought, suggesting that the economic forces underpinning the growth of consumption in wealthier, more urban markets are stronger than investors had believed. This strengthens the outlook for at least some of the H-share companies, Ng told us. Further, signs of sustainability in consumer growth are suggestive of more stable profit margins. Confidence in the resilience of these profits coupled with increasing recognition that the mainland firms listed in Hong Kong are among the best in terms of corporate governance is another factor bolstering H-shares, in Ng's view.

... AND GREATER ECONOMIC BALANCE AS WELL

17. (C) Goldman Sachs Managing Director Hong Liang told us that the rally represents growing investor confidence in the ability of China's economy to sustain high rates of economic growth, but she drew a contrast between market sentiment and her own views, which are more pessimistic. Investors, she said, are positively reassessing China's macroeconomic health, and they see an economy tending towards greater

balance with regard to continued expansion generated by exports, investment, and domestic consumption. There is also increasing confidence, perhaps misplaced, in Beijing's ability to manage China's economy in the coming years, especially given its perceived bias towards stimulating domestic demand. Investors additionally believe that as the sustainability of high levels of growth becomes evident to policy makers, they will grow more comfortable in letting the RMB appreciate. Liang predicted a 3-5 percent RMB appreciation this year.

A CAUTIONARY NOTE

¶8. (C) Liang said that mainland policy makers might fail to manage the current economic cycle properly by reacting too slowly. She thinks that economic activity is understated and that policy makers are likely to wait until after first quarter data are finalized to see that this is the case and then respond. Liang termed China's slow response to the need for RMB appreciation a "worst case approach" towards macroeconomic management and asserted that continuing in this way will lead to inflationary pressures amidst rising commodity prices. The result will inevitably be "bubbly stuff somewhere." But by reacting too late, authorities will find themselves hesitant to prick the bubbles with higher interest rates out of fears of hurting other sectors of the economy that need to keep growing. Consequently, they may once again resort to administrative approaches; such arbitrary non-market measures could quickly change investor sentiment.

H-SHARES TO JOIN HONG KONG'S BENCHMARK INDEX

¶9. (SBU) H-shares account for a significant proportion of foreign investor interest in the Hong Kong exchange, yet they are not represented on the benchmark HSI. They are barred from the index because the ownership held by state-affiliated parent firms is often in the form of "non-tradable" shares that cannot be bought or sold. To reform the Shanghai stock market, China is presently converting non-tradable shares of companies listed there (A-shares) to tradable shares. This will open the way for H-share firms in Hong Kong to join the HSI for two reasons. First, some H-share firms are also listed as A-share firms in Shanghai, so the

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Shanghai-initiated conversion to tradables affects some companies listed here and will make them eligible to join the HSI. Second, Chinese firms that have not yet listed as H-shares or A-shares will be more inclined to list as fully tradable the first time around, thus qualifying them up front for HSI constituent status.

INTEGRATION AND TRANSFORMATION

¶10. (C) We note that loading the HSI up with PRC firms symbolizes Hong Kong's further integration into the mainland's economy. It will also draw those who invest in Hong Kong's market away from traditional property and banking concerns located here and into companies based in the PRC. This is because fund managers often allocate investments against a basket of shares like the HSI. Therefore, if the HSI is weighted less towards companies like HSBC (bank) and Sun Hung Kai (property) and more towards H-shares like China Construction Bank and Angang Steel, then foreign funds will flow accordingly.

Sakaue